

BEFORE THE DEPARTMENT
OF PUBLIC SERVICE REGULATION
OF THE STATE OF MONTANA

IN THE MATTER of the Petition)
of Big Horn Energy Partners)
and Montana Power Company for) DECLARATORY RULING
a Declaratory Ruling Re Com-)
mission Order No. 5017.)

BACKGROUND

1. On or about September 10, 1984, Big Horn Energy Partners, a Montana Limited Partnership (hereinafter Big Horn), petitioned the Commission for a Declaratory Ruling under Section 2-4-501, MCA, and ARM 38.2.101 and 1.3.227 of the Commission's procedural rules.

2. In its Petition, Big Horn was seeking a declaratory ruling that the proposed security provision in its power purchase agreement with the Montana Power Company (hereinafter MPC) adequately protected the interests of MPC's ratepayers, and was therefore an acceptable form of security under Commission Order No. 5017, Docket No. 83.1.2.

3. In the Petition, it was further alleged by Big Horn that the Commission's assumption in Order No. 5017 of the availability of "project failure" insurance was no longer valid, as said insurance was either not available, or was economically prohibitive.

4. The overall Big Horn proposal involved the revitalization of the Holly Sugar Co. plant, north of Hardin, Montana. Originally, Big Horn proposed to spend approximately \$55-60 million to construct a 10 million gallon ethanol refinery and cogeneration facility, capable of producing 15 MW of electricity. The bulk of the electricity produced would be sold to MPC and the proceeds would be used to secure the debt on the project. The project would also produce brewers dried grains to be used as a high protein feed supplement for dairy cattle. Later in the proceedings, the construction figures were revised to \$35 million. In addition, and in recognition of the uncertainty surrounding the future of the ethanol market, the projected ethanol production was reduced to one million gallons per year.

5. During the proceedings held in this matter, many alternative security provisions were discussed as potential options. All of the options considered had one common thread: The cogeneration facility itself was to be used as part of the security for performance under the fully levelized power purchase agreement. The final proposal by Big Horn is the subject of this ruling. For security purposes, Big Horn would grant to MPC a second lien on the facility. The lien would be subordinate to that of a primary lender. The value of that second lien would be determined by further negotiation between the parties, although a preliminary study of the replacement value of the facility over the life of the contract was provided by Big Horn. The level of security required to fully protect the ratepayers during the term of the

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power purchase agreement was generally agreed to be approximately \$40 million. Any additional security beyond the value of the second lien which was needed to reach this level would be provided by Big Horn through the use of a cash escrow.

6. On September 24, 1984, MPC filed its response to Big Horn's Petition. Briefly, it was the position of MPC that use of the cogeneration facility for the purposes of security in the fully levelized power purchase agreement did not comply with the requirements of Order No. 5017, Docket No. 83.1.2. According to MPC, the terms of that order required full ratepayer security in a fully levelized power purchase agreement. Since Big Horn was unable to provide other security deemed acceptable under Order No. 5017, the only remaining option was a cash escrow for the full level of security required.

7. Although initially raised as an issue, during the proceedings Big Horn essentially dropped its challenge of the validity of the Commission's assumptions surrounding the availability of project failure insurance. The need for further consideration of this issue was eliminated when Big Horn agreed to accept MPC's interpretation of Order No. 5017 as requiring full (100%) ratepayer security in a fully levelized power purchase contract.

8. Essentially, the parties were requesting an interpretation of Order No. 5017, Docket No. 83.1.2 as it applied to their proposed power purchase agreement. Specifically, whether the security proposal of Big Horn, as outlined above, was sufficient to meet the requirement of full (100%) ratepayer security as required in a fully levelized power purchase agreement.

9. Because of the potential broad application of this ruling, an opportunity for comment was offered to all interested developers of qualifying facilities who were then involved with MPC. Comments were received from several developers of small hydropower, including Mitex, Inc., Potosi Power, Inc., Montana Natural Energy, Inc., and Hydro-Dynamics, Inc. In general, all of the comments were supportive of the Big Horn proposal, although some of the comments were careful to draw clear distinctions between the risks associated with Big Horn's cogeneration project and those risks inherent with a small hydropower project.

10. In addition, comments were received from several local residents and businesses in the area of Hardin, Montana, where Big Horn's proposed cogeneration facility would be located. All of the comments were in support of the Big Horn proposal, generally citing the need for economic development and positive growth in the Hardin area.

11. At request of the parties, an informal hearing was held by the Commission on August 26, 1985. With the consent of the parties, and at the request of the Commission, an additional informal hearing was held on October 4, 1985. At these hearings, both parties were given the opportunity to present

testimony and evidence in support of their position. Both parties agreed to be bound by any Commission decision arising out of these hearings.

Analysis and Finding

I. The Positions of the Parties

12. The Big Horn security proposal at issue in these proceedings consists of two parts. The first part of the security is the granting of a second lien on the cogeneration facility to MPC. The second part consists of a substantial cash escrow, containing an amount sufficient to make up the difference between the value of the second lien, and the level of security required to provide full ratepayer security under the agreement (\$40 million).

13. MPC did not contest the use of the cash escrow portion of the security proposal. It was the use of the cogeneration facility for security purposes that was questioned. With all of the risks attendant with that facility, MPC asserted that it did not represent "risk free" security to the ratepayer, as required in Order No. 5017.

14. It was Big Horn's position that the cogeneration facility was of substantial value to MPC's ratepayers over the term of the contract as a source of electricity. Accordingly, it was appropriate to use the facility itself and its corresponding value for security purposes.

15. MPC responded by contending that there were too many factors which could adversely affect the long-term value of the plant as a source of electricity. If any one of the various by-product markets experienced a substantial decline, it could be uneconomical to continue operation of the cogeneration facility. Further, should MPC be required to operate the plant in the event of default, the costs of operation then become part of MPC's system costs, and all benefits from the Big Horn contract would be lost. Further, there may be other sources available which would be more economical. Finally, MPC argued that as a second lien holder, their rights, and by extension, the rights of the ratepayers, would be subordinate to the first lien holder. There would be a distinct possibility that, in the event of default by Big Horn of its first obligation, the second lien would be of no value.

II. The Commission's Decision

16. It is correct to interpret Order No. 5017, Docket No. 83.1.2 as requiring full, or 100 percent, ratepayer security in a fully levelized power purchase contract. This strict interpretation is supported by the fact that the avoided cost prices of Docket No. 83.1.2 do not reflect risk allocation. Instead, that issue was left for negotiation between the parties on a case-by-case basis. If the avoided cost prices of Docket No. 83.1.2 would have reflected risk allocation, then in all likelihood, they would have been much lower. See

Superior Energy, Inc. v. Pacific Power & Light Co., Docket No. 84.8.46, Order Nos. 5137 and 5137a.

17. This Commission has rejected the notion that policy considerations warrant encouragement of cogeneration and small power production at any cost. See Docket No. 81.2.15, Order No. 4865.

18. For the parties involved, a long-term levelized power purchase contract is a gamble. The small power producer accepts a fixed rate contract. Under levelization, they receive payment for services to be rendered in the future. In return, they agree to sell their product at a fixed rate over the long-term of the contract, regardless of what their product may actually be worth. For the purchasing utility, and by extension its ratepayers, the small power producer is subsidized in the short run, for the promise of cheaper power in the later years of the contract. Assuming that the cost of power will increase in the future, the production of power by a collective group of small power producers over the full term of their respective contracts would prove beneficial to the ratepayers.

19. The question faced by the Commission in this Docket has been characterized as a security issue. In reality, it is the proper allocation of the burden of performance of the terms of the power purchase contract.

20. A central issue in this Docket has been the effect of Big Horn's default under the power purchase agreement in the later years of the contract. Big Horn has stated that in the event of its default, the ratepayers will still benefit if someone else operates the plant through the remainder of the contract.

21. The Commission rejects that argument. It is clear that if Big Horn defaults under the terms of its power purchase agreement with MPC, all benefits to the ratepayers from that contract will be lost. Accordingly, the Commission strives to prevent default altogether, not to merely mitigate its effects upon the ratepayers.

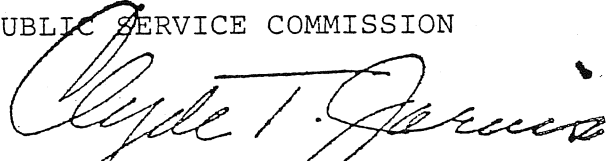
22. Big Horn's proposal places the burden of assuring its performance of the terms of its power purchase contract on MPC, and thus upon the ratepayers. Clearly, only Big Horn should bear the responsibility associated with its performance under the terms of the power purchase contract. If the facility is not accepted as security, and other means of security are provided, the burden has been properly placed on Big Horn to perform throughout the life of the contract. In the event of default, Big Horn will have something to lose. To accept anything less would be a disservice to MPC's ratepayers, and in contradiction to the express direction of Order No. 5017, Docket No. 83.1.2.

23. Accordingly, the Commission finds and declares by law that Big Horn's security proposal, as described herein, does not satisfy the "full ratepayer security" standards of


Order No. 5017, Docket No. 83.1.2. The relief requested by Big Horn in its Petition for Declaratory Ruling is Denied.


APPROVED BY THE COMMISSION October 11, 1985.


BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION


CLYDE JARVIS, Chairman

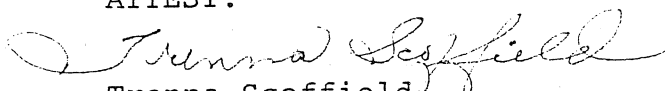

HOWARD L. ELLIS, Commissioner


DANNY OBERG, Commissioner


JOHN B. DRISCOLL, Commissioner
(Voting to Dissent)


TOM MONAHAN, Commissioner
(Voting to Dissent)

ATTEST:


Trena Scofield
Secretary

(SEAL)

NOTE: Any interested party may request the Commission to reconsider this decision. A motion to reconsider must be filed within ten (10) days. See 38.2.4806, ARM.

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